

McCarthy Asset Management, Inc.

Registered Investment Advisor

October 2, 2007

Dear Client,

In one of the most volatile quarters in years, stocks fell nearly 10% before staging a strong recovery, which resulted in modest gains for the full quarter. Bonds and international stocks also rose modestly, while commodities rose sharply.

With this report for the quarter ending September 30, 2007, I discuss the third quarter and year-to-date market and MAM portfolio performance, as well as what caused the extensive volatility within the quarter. In addition, I provide my outlook for real estate, the economy and the stock market. I end with a discussion of steps I am contemplating for the 4th quarter portfolio repositioning.

Enclosed are four 9/30/07 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 3rd quarter and YTD 2007 portfolio rates of return
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Realized Gains and Losses*: YTD 2007 investment realized gains and losses (included only for taxable accounts).

Stock Market & MAM Performance for the Third Quarter

With the exception of small stocks, the stock market rose moderately for the third quarter of 2007. The S & P 500 climbed 1.6% to 1527, the Nasdaq jumped 3.8% to 2702, and the Russell 2000 fell 3.5% to 834. These returns do not reflect reinvestment of dividends.

For the quarter, 2% of the MAM portfolios that were in existence for the whole quarter had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 1.0% (after MAM fees) versus a gain of 2.0% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

The underperformance of MAM portfolios relative to the S & P 500 was due to two factors. The first was the negative return from small stocks, as indicated by the 3.5% drop in the Russell 2000 for the quarter. The second was the impact of strong performance of large cap growth stocks, which returned 6.2% for the quarter. After dominating during the late 1990's, large cap growth stocks have

since been among the worst performing stocks (the Nasdaq index is still down nearly 50% from its peak in March of 2000). For the last couple of years, many analysts have been predicting their reemergence. While I have been gradually increasing the exposure to large cap growth (i.e. AMCAP Fund, Growth Fund of America, and Columbia Marsico 21st Century), MAM portfolios are still under-weighted in large-cap growth stocks relative to the S & P 500. See “Next Portfolio Repositioning” below for a discussion of steps that I am contemplating for the 4th quarter portfolio repositioning.

Best Performers: The eight best performing MAM investments for the quarter were PIMCO Commodity (up 9.8%), Artisan International Small Cap (up 8.8%), Blackrock Health Science (up 6.9%), Columbia Marsico 21st Century (up 6.1%), Capital World Growth & Income (up 5.1%), Calamos Growth & Income (up 4.9%), Growth Fund of America (4.4%), and PIMCO Developing Local (bonds) (up 4.2%).

Worst Performers: The eight worst performing MAM investments for the quarter were Artisan Small Cap Value (down 7.5%), Oakmark International Small Cap (down 6.6%), Oakmark Select (down 6.5%), Allied Capital (down 3.0%), iShares Dow Jones Select Dividend (down 2.8%), William Blair Small Cap (down 2.2%), FMI Large Cap (down 1.3%), and Cambiar Opportunity (down 1.1%).

Stock Market & MAM Performance for YTD 2007

For the first nine months of 2007, the S & P 500 rose 7.7%, the Nasdaq climbed 11.9%, and the Russell 2000 rose 2.2%. These returns do not reflect reinvestment of dividends.

For the first nine months of 2007, 2% of the MAM portfolios that were in existence for the whole period had performance that was equal to or greater than that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 6.7% (after MAM fees) versus a gain of 9.1% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of September 30, 2007, the original \$50,000 had risen to \$97,195, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 96.8%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 24.7%. For the quarter ending September 30, 2007, the portfolio rose 0.9%, while for the first nine months of 2007 it rose 6.7%. All returns quoted for this portfolio (and for all portfolios) are net of MAM fees. Also, past performance is not necessarily an indicator of future performance.

What a Crazy Quarter

From July 13th through August 15th, the S & P 500 fell 9.4%. The sell-off was triggered when short-term liquidity in the credit markets all but froze up. Things got so bad that major banks were unwilling to lend even to each other, immobilizing the global financial system. The central banks of Europe, Japan, Australia and the U.S. stepped in by injecting cash into the global financial system. The markets also began to anticipate a Fed rate cut at the September policy-making meeting. The Fed came through on September 18th with a ½ point cut in the federal funds rate (to 4.75%). The

stock market responded with a resounding “Yes!” as the S & P 500 rose 2.9% the day of the announcement.

Economic and Investment Outlook

Real Estate: Most of you have probably felt little if any impact from the real estate downturn. Prices in the Bay Area and other coastal markets may have dropped only modestly. My understanding, though, is that in the California Central Valley (Fresno, Bakersfield, etc.) and other areas where there have been significant new home construction, prices have fallen as much as 30% to 35% from their peak. The most recent statistics have been disappointing. Sales of existing homes throughout the U.S. fell sharply in August, to the lowest level in seven years. By one measure, home inventories rose to an 18-year high.

Conditions within the real estate markets will probably worsen in the short run. The impact of the July/August credit turmoil is just starting to be felt. Also, foreclosures are rising sharply. For the month of August, Nevada, California and Florida had the highest foreclosure rates in America. California reported the most foreclosure filings with 57,875, one for every 224 households. This was up 48% from the previous month and up 300% from August 2006. The increase in foreclosures adds to the inventory of unsold homes, which puts further downward pressure on home prices. Finally, I recently read that for the month of October of 2007, the interest rate on a record amount of adjustable rate mortgage debt will adjust upward, putting further pressure on homeowners to make their mortgage payments.

Help is on the way. The Federal Reserve’s September 18th cut of ½% in the federal funds rate will gradually reduce the rate on many of the adjusted rate loans. I expect the Fed to announce additional cuts in the federal funds rate during the next few months. Also, a bill in Congress which is expected to pass will expand the ability of the FHA to make mortgage loans. Given the multi-year nature of real estate downturns, though, my feeling is that it will not be until at least late 2008 or early 2009 before residential real estate starts to recover.

The Economy: Housing represents a relatively small portion of the economy, historically accounting for about 5% of gross domestic product (GDP). The greater impact of housing is on consumer spending since home ownership is the most important asset of many households. In a paper presented at a recent Federal Reserve conference by Ed Leamer, head of the forecasting center at UCLA’s Anderson School of Management, weakness in residential investment dampened GDP growth before eight of the past ten recessions. The dismal housing market is now worrying consumers, raising fresh concerns about economic growth. A recent report on consumer confidence indicated a drop to the lowest level in two years.

The economy is expected to slow during at least the next couple of quarters. Some economists are predicting a recession (which is defined at two consecutive quarters of negative growth in Gross Domestic Product). Recently, Alan Greenspan, former Chairman of the Federal Reserve, predicted the odds of an upcoming recession as between 33% and 50%. The question is whether Federal Reserve interest rate cuts and the strength of foreign economies (which are boosting U.S. exports) will be sufficient to avoid a recession.

The Stock Market: I have been surprised at how quickly and dramatically the stock market recovered from the July-August downturn. The market is now back close to the year’s high. As mentioned above, the economy is expected to slow sharply in the third and fourth quarters of 2007. Furthermore, for the third quarter of 2007, companies in the S & P 500 are expected to post the

lowest earnings growth rate in five years. The expected earnings downturn is primarily due to the negative impact of Financial companies, which are expected to post an earnings decrease due to the problems in the credit markets.

I would be surprised to see the stock market continue its strong rally. My expectation is that the sharp six-week recovery will stall, and volatility will return. My mid-term outlook of the stock market performance (i.e. for the next one to three years) is with guarded optimism. While I am concerned about the pending economic and corporate earnings slowdown, I feel that the Federal Reserve will cut interest rates as much as needed to avoid a recession. Historically, the Fed is very careful to avoid a recession in a Presidential election year. Also, I expect that strength in foreign economies will continue to provide stimulus through the growth in U.S. exports.

As I said in last quarter's report, "given its strong performance during the past quarter, the consistent rise for the last five years and the recent increase in volatility, I would not be surprised to see a short-term drop in the stock market. Such a correction could be healthy as bull markets typically experience one or more 10% corrections." While I said I wouldn't have been surprised with a drop in the market, I did not expect an almost 10% drop in just 4 weeks. With the exception of one client, fortunately, MAM clients resisted the urge to become more conservative. Most investors that did panic in the July-August downturn probably missed the subsequent dramatic recovery.

Also as mentioned in last quarter's report, "I think it is foolish for investors, though, to try to time these short-term market movements, and studies show that most investors fail miserably in such efforts. More importantly, the domestic and international economic outlooks are good, and due to the strong increase in corporate earnings, stocks are reasonably priced. My advice continues to be to invest based on your risk tolerance, stay diversified, and maintain a long-term outlook." I still agree with this outlook, although I wouldn't be surprised to see short-term dips in the market during the next few months.

Next Portfolio Repositioning

It has been my practice to reposition portfolios twice per year. The next repositioning will be done in the fourth quarter of 2007. Below I have comments regarding what I mean by "repositioning", what steps were taken in prior repositions and what steps I am contemplating next.

What is Repositioning?: Many investment advisors periodically rebalance their portfolios to their target allocation. For instance, their target for a moderate portfolio could be 40% U.S. large cap, 10% small-mid cap, 35% bonds and cash, and 15% International equities. Portfolios become out-of-balance with their targets due to gyrations in stock prices. For instance, if international stocks rise sharply and bonds fall, a rebalancing would be done to sell a portion of the international equities and purchase bonds. Studies have shown that over time, periodic rebalancing improves investment results. This may be intuitive, as rebalancing is a way to sell high (international equities in this case) and buy low (bonds).

Since the stock market is dynamic, I take rebalancing a step further. Rather than adjust asset class weightings to a fixed percentage, I adjust the target allocation based on my outlook for the relative performance of each asset class. I underweight those areas that I feel are overvalued and overweight those that are undervalued. I practice rebalancing to help portfolios stay ahead of the dynamic, ever changing stock market.

Prior Repositioning: I started MAM in September of 1999. The first repositioning I did was in the Summer of 2000. At the time, I reduced the exposure in technology-weighted funds, and purchased a small cap value fund (Artisan Small Cap Value) and Cohen & Steers REIT. During the late 1990's technology stocks, particularly large cap, was the best performing asset class. Small-cap value funds and REITs were dismal performers during this dot-com boom. Although it only became clear later, by 2000 technology stocks had become dramatically overpriced and small cap value and REIT stocks were much undervalued. The Summer of 2000 repositioning was beneficial as during the next six years, small cap stocks significantly outperformed large cap stocks and REITs soared.

For the last two years I have felt the small cap stock and REIT out performance was coming to an end. As a result, I have been shifting small cap exposure to large cap, and substantially eliminating REIT exposure. For instance, as of 9/30/05, small cap funds made up 11.6% and REITs 3.1%, respectively, of MAM portfolios. As of 9/30/07, the weighting in small cap funds was reduced to 3.5% and REITs to 0.4%, respectively, of MAM portfolios.

Not all my repositioning efforts end up benefiting performance. After under-weighting technology exposure for five years, I added a technology fund to most portfolios two years ago. This proved to be pre-mature, as technology stocks continued to lag the overall stock market for at least another year. Also, the efforts so far to diversify into alternative assets have shown mixed results. Since adding PIMCO Commodity two years ago and Allied Capital one year ago, both have provided only modest results.

Possible Steps For Next Repositioning:

1. **Increase in Large Cap Growth:** I expect to add another large cap growth fund. Among the funds I am considering are Vanguard Primecap Core, Hartford Capital Appreciation, CGM Focus, and the exchanged traded fund iShares Russell 1000 Growth Index Fund. I expect to increase large cap growth by reducing exposure to large and mid-cap value, and small cap funds.
2. **Adjustment To Commodity Exposure:** While I expect to maintain the current 2.5% to 3.0% commodity exposure in portfolios, I may replace PIMCO Commodity with either an exchange traded commodity fund or a natural resource fund.
3. **Shift iShares D.J. Select Dividend to International?:** iShares D.J. Select Dividend (symbol DVY) was first purchased in portfolios in October of 2004. Since then this exchange traded fund of high-yielding U.S. stocks has been a solid performer. Recently iShares introduced a new exchange traded fund, iShares Trust D.J. Epac Select Dividend (symbol IDV). This fund is the international version of DVY. A significant difference is that, because the average dividend yield in many foreign markets is much higher than in the U.S., it offers an annual yield of 4.3%, versus DVY's 3.4%.

A common theme in each of these contemplated steps is that I may use an exchange traded fund to gain exposure to an asset class. While most exchange traded funds are passively managed to an index, they offer the advantages of very low operating expenses and tax efficiency (i.e. little or no realized capital gains). Although it is not a significant cost, for clients with less than \$1 million in Schwab accounts, the transaction fee to purchase an exchanged traded fund is \$19.95 if they are not signed up for eDelivery. The commission rate is cut to \$12.95 if they are signed up for eDelivery with Schwab (which most MAM clients are). *If you are not sure if you are signed up for eDelivery,*

please call or email Marilyn (marilyn@mamportfolios.com) to find out. Billy can also assist you in signing up for eDelivery.

Assets Under Management

As of September 30, 2007, MAM assets under management were in excess of \$113 million, up from \$100 million at the start of the year. Existing and new clients added over \$5 million in net assets during the first nine months of 2007.

The majority of new MAM clients come from client referrals. I appreciate these referrals and continue to welcome them. The minimum amount to manage for new clients is \$600,000.

Please call me if you wish to discuss the stock market or your portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA, CFP

encl: Investment Reports